Managing through an economic downturn: personal finance, a consumer guide

American Institute of Certified Public Accountants. Communications Division

Scale back on discretionary spending

It shouldn't be too hard to find several relatively painless ways of increasing your family's financial security. Here are some suggestions.

- Take an off-season vacation or postpone this year's vacation until better times.
- Consider expanding or remodeling your home instead of moving.
- Eat out less frequently, and when you do, explore the neighborhood to find new, less expensive restaurants.
- Take the time to compare prices and shop for bargains. Clipping food coupons is a good habit that will save you money on your grocery bill.
- Learn to make sacrifices, such as buying a used car for the family instead of the newest model.

Surviving a Downturn

Following are some tips that can help you make it through an economic downturn.

- Reduce debt by establishing a plan. For instance, make a list of everything you owe, including the interest rate paid. Tackle the credit card balance on which you pay the highest interest first. Then, systematically pay off the other card balances by paying more than the minimum payment each month. In the meantime, use the card with the lowest balance for new purchases and pay it off monthly to avoid finance charges.
- If you intend to remain in your current home for at least three more years and prevailing residential mortgage rates are at least 2 percent lower than the rate you're paying, refinance your mortgage to take advantage of lower rates.
- If you're financing a car, take out a 36-month loan. Finance it for a longer term only if you're short of monthly cash.
- If you must move and can't find a buyer for your home, consider renting it. Not only can the rent cover your mortgage payments, but you may be eligible for a depreciation deduction at tax time. The rules are complicated, so make sure you talk to your CPA first.

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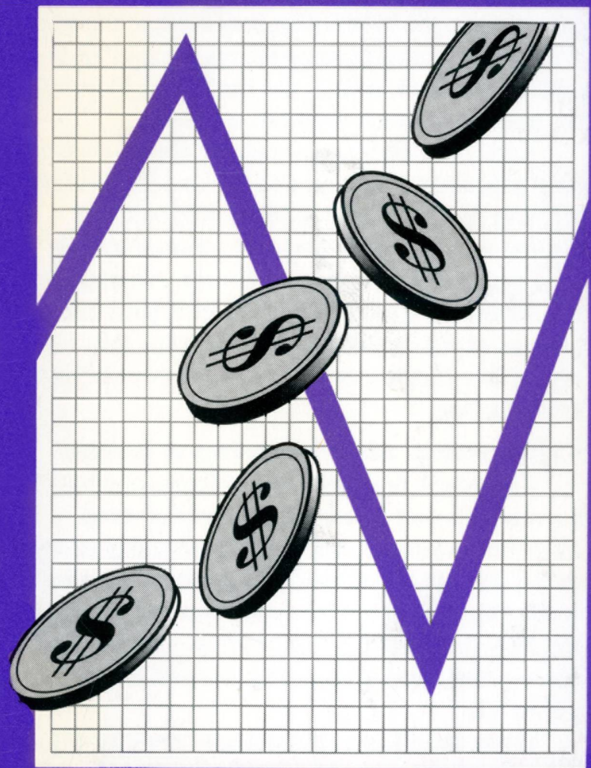
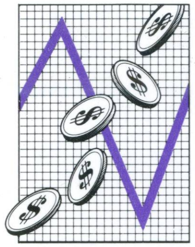
A CONSUMER GUIDE

PERSONAL FINANCES

Managing Through an Economic Downturn





When the economy takes a downturn, wise consumers usually respond by changing their financial behavior. Here are some basic guidelines that can help you make the financial adjustments necessary to survive an economic downturn.

Clear objectives are essential

In difficult times, there's less room for ambiguity in defining financial goals. Are you planning for retirement? Trying to pay off your credit debt? Saving to buy a home? All of the above? Different goals dictate different strategies.

Think the unthinkable

It's important to have a nest egg in case you suddenly lose your main source of income. CPA financial planners say you should have at least three months to a year of income set aside, depending on your current income, family needs, and potential job opportunities.

If you're having trouble finding another job, think about relocating. Certain labor experts say that the Northwest and Midwest will have above-average job growth in the 1990s. Also, look at other industries. While employment in some sectors is expected to decline, in others, such as the health care industry, the number of jobs is expected to grow.

Keep in mind that you may be able to deduct such job-hunting expenses as the cost for producing your resume, travel to job interviews, and postage and telephone costs for communicating with potential employers. However, remember that job-hunting costs are included in your miscellaneous expenses, which are deductible only to the extent that they exceed 2 percent of your adjusted gross income.

Think twice about buying a house

One of the few advantages of an economic downturn is that housing prices tend to drop. However, buying a house at this time is a good idea only *if* you can afford the down payment and closing costs without dipping into your nest egg. Consider, too, how unforeseen circumstances—such as losing a job—may affect your ability to make mortgage payments.

If you can afford to buy a home, you'll be happy to know that it is one of the few major tax-deductible investments still available to consumers. Not only can you generally deduct mortgage interest on first and second homes, but you can also deduct real estate taxes, interest on home equity loans of up to $100,000, and in some cases, points paid to secure a mortgage.

What's more, if you sell your home, you won't have to pay tax on the capital gains as long as you buy a new home for a price equaling or exceeding the adjusted selling price of your previous home. Also, if you or your spouse are at least 55 years old, you may be able to exclude from taxable income up to $125,000 of the profit realized from selling your principal home.

Limit your borrowing

Borrowing to purchase goods or to pay bills jeopardizes your future financial security. In good times, your monthly debt payments (not counting your mortgage) shouldn't exceed 20 percent of your take-home pay. In a recession, you should trim your debt to 15 percent at most.

Consumer credit is probably your worst option for borrowing funds. This is especially true now that interest on personal debt is no longer deductible and annual percentage rates routinely exceed 18 percent. It is crucial that you pay off your credit cards and reduce your debt. A CPA can help you determine how long it will take you to pay off debts given the interest rate and the monthly payment you can afford. For example, assuming a 20-percent interest rate, it would take you one year to pay off $1,000 if you made monthly payments of $90.

In most cases, a home equity loan is likely to be a much more advantageous way of borrowing: not only are the rates lower, but the interest charges generally remain deductible. Before considering a home equity loan, however, make sure you will be able to make the monthly payments. If not, you may risk losing your property.

Your 401(k) should be a last-resort option for borrowing funds. For those who have not reached the age of 59 1/2, there is a 10-percent penalty in addition to full income tax liability if you dip into your 401(k) for anything other than an emergency. Contact your CPA for more information on what qualifies as a hardship withdrawal.

Plan for your retirement

Social Security shouldn't be the cornerstone of your retirement planning. Economically and politically, many of the assumptions on which current projections are based may be too optimistic. And soaring health care costs are almost certain to increase the pressure on Social Security—and on you. CPAs recommend contributing as much as you can afford to tax-advantaged retirement plans, such as a 401(k), a Keogh, or an IRA.

Remember that Social Security is only one, and not the most important, of four potential sources of retirement income. The others are your personal savings, your investments, and a company pension, if you have one.

Be more careful about investing...especially now

In uncertain times you may want to move some of your riskier investments into sounder vehicles, such as money market accounts.

In weighing investment opportunities, consider the true yield as well as the risk. Don't overlook management fees and other expenses that diminish your rate of return. And always measure your gain in after-tax dollars.

Rethink your insurance coverage

If there are family members who depend on your income, your life and disability coverages should be at least five times your annual income. This depends on how long your beneficiaries' financial dependency can be expected to continue. However, if you regard it primarily as an investment, life insurance may not be your best option since interest rates tend to be modest and premiums aren't deductible.

As for your property, auto and casualty insurance, consider increasing your deductible to considerably reduce your premiums.

Consult a professional

The financial approach you take to achieve your goals depends on your particular situation. In troubled times, one fact is paramount: The only way to achieve positive long-term results is to develop well-conceived, long-term goals and strategies—and stick to them. A CPA is a valuable source of information and advice as you consider various personal financial planning options.